

General Information Letter: No subtraction modification is allowed for losses passed through from a partnership and disallowed in computing federal adjusted gross income of the partner in order to reflect a pro-forma recomputation of the federal loss limitation to take into account Illinois addition modifications.

June 13, 2006

Dear:

This is in response to your letters dated August 22, 2005 and March 7, 2006, which were referred to this office for reply. The nature of your letters and the information provided require that we respond with a General Information Letter (GIL). A GIL is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be accessed from the Department's web site at www.ILtax.com.

Your letter of August 22, 2005 states as follows:

Reference is made to your notice dated August 1, 2005, copy attached, which the taxpayer has forwarded to our office for review and response.

In your notice you indicate that the taxpayer was disallowed the other subtraction listed on line 9 in the amount of \$60,836.

Please be advised that the taxpayers were required to report a depreciation addition of \$102,070 on line 3 of form IL-040 as the result of a depreciation addition reported to Mr. Z on schedule K-1-P from COMPANY, Inc. (XX-XXXXXXX). Mr. Zs' distributive share of the losses from COMPANY, Inc. as reported on federal schedule K-1 and Illinois schedule K-1-P was \$60,836. Due to basis limitations, Mr. Z was unable to utilize the loss on his federal income tax return (copy enclosed), which would have reduced his federal adjusted gross income. Effectively, the inclusion of \$102,070 of the depreciation addition provided him with additional basis to take the loss on Form IL-1040. That amount has been included on Line 9 of form IL-1040 as originally filed.

Based on the information above and enclosed, we are respectfully requesting that the tax, interest, and penalty assessed be abated and the return be accepted as filed.

Your letter of March 7, 2006 states as follows:

My office in (sic) receipt of your Error Notice Response dated March 3, 2006 (copy enclosed) received by the above referenced taxpayer. Your response indicates a determination disallowing a subtraction taken by the taxpayer on line 9 of form IL-1040 for the period ended December 31, 2004 in the amount of \$60,836.

Please be advised that I and the taxpayer respectfully disagree with your decision based on the facts detailed below:

The taxpayer is a 51% shareholder in COMPANY, Inc. (XX-XXXXXXX) and for the tax year ended December 31, 2004 Mr. Z received a K-1 from the corporation indicating an ordinary loss on Part III, line 1 in the amount of \$60,836 (copy of form K-1 enclosed).

Due to basis limitations the taxpayer was unable to claim the loss on Federal form 1040 for the year ended December 31, 2004 (copy of form 1040, page 1, schedule E, page 2 and form 6198 enclosed).

COMPANY, Inc. issued to the taxpayer schedule K-1-P indicating an other addition in the amount of \$102,070 for a depreciation addition, as Illinois tax code did not recognize the bonus depreciation enacted in to (sic) law by the Federal government in 2001 (copy of schedule K-1-P enclosed).

IL-1040, step 2, line is (sic) Federal adjusted gross income from U.S. 1040, line 36, which for the taxpayer includes no loss from K-1 issued by COMPANY, Inc.

The purpose of IL-1040, step 2, line 3 is to add in or back amounts either not taxable by the Federal government or items deducted in arriving at Federal adjusted gross income, not deductible for Illinois purposes. The depreciation adjustment reported by COMPANY is added back at this point, which effectively creates "phantom" income to the taxpayer, as an addition is included on the Illinois return for which no deduction was taken on the federal income tax return

Based on this information and the overall matching principle of income and deductions, we are respectfully requesting that the taxpayer's return be accepted as filed and that all penalties and interest assessed be abated.

RULING

As explained below, the Department properly disallowed your client's (Taxpayer) claimed subtraction modification for a distributive share of ordinary loss from an S corporation. In addition, the Department correctly treated such claimed subtraction as a mathematical error under section 1501(a)(12)(D) of the Illinois Income Tax Act (IITA), thereby resulting in additional tax being deemed assessed under section 903(a) of the IITA. In order to avoid further collection action, Taxpayer should pay the additional tax, penalty, and interest as instructed in the Department's notice.

The Illinois income tax is imposed under section 201 of the IITA on a taxpayer's "net income." IITA section 202 defines "net income" in the case of an individual as that portion of the taxpayer's "base income" allocable to Illinois under the provisions of Article 3, less the standard exemption allowed under section 204. IITA section 203(a) defines the term "base income" in the case of an individual to equal the taxpayer's adjusted gross income for federal income tax purposes, as modified by certain statutorily prescribed addition and subtraction modifications. Where the taxpayer is a partner in a partnership or shareholder in a subchapter S corporation, Department forms require that the taxpayer include in base income his or her distributive share of addition and subtraction modifications attributable to the partnership or S corporation. Under IITA section 1501(a)(19), the term "regulations" includes forms prescribed by the Department. IITA section 203(h) states that there are no modifications to base income except as expressly provided by such section. In the case of a resident, section 301(a) allocates to Illinois all items of income and deduction taken into account in computing base income.

IITA section 1501(a)(12)(D) defines the term "mathematical error" to include any attempt to claim, exclude, or deduct in a manner directly contrary to the IITA or Department regulations any item of

income, exemption, deduction, or credit. Therefore, claiming a subtraction modification for which there is no provision in IITA section 203 constitutes a mathematical error. Department of Revenue v. Walsh, 196 Ill. App. 3d 772 (1st Dist. 1990). IITA section 903(a)(1) states that in the event that the amount of tax is understated on the taxpayer's return due to a mathematical error, the Department shall notify the taxpayer that the amount of tax in excess of that shown on the return is due and has been assessed.

Applying the above provisions to the Taxpayer in the instant case, IITA section 203 does not provide a subtraction modification for the distributive share of S corporation losses not taken into account in computing adjusted gross income due to the basis limitations of Internal Revenue Code section 1366(d). The addition and subtraction modifications required under section 203 do not affect, and are to be taken into account without regard to, a shareholder's adjusted basis in the S corporation stock. Therefore, the addition modification for bonus depreciation passed through to Taxpayer from COMPANY, Inc. does not increase the taxpayer's adjusted basis in the corporation's stock for federal, and therefore Illinois, income tax purposes; nor does it allow the taxpayer to claim a subtraction modification for losses of an S corporation not otherwise taken into account for federal income tax purposes.

Accordingly, Taxpayer's attempt to deduct the S corporation ordinary loss as a subtraction modification is directly contrary to IITA sections 203(a) and (h), and, as such, constitutes a mathematical error under section 1501(a)(12)(D). The additional tax is deemed assessed under section 903(a)(1), as indicated in the Department's prior notices.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you have questions regarding this GIL you may contact Legal Services at (217) 782-7055. If you have further questions related to Illinois income tax laws, visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)